Lessons for Leaders

THE TOP FIVE CORPORATE CULTURE STORIES OF 2015

Daniel R. Denison, Ph.D.

This past year

gave us a rich collection of compelling stories that remind us of the powerful impact that an organization's culture can have on their survival and growth. These stories all present a close link between the character of a corporation and the successes and dramatic failures that they can experience. Culture has become an important concern for leaders in all types of organizations as they strive to understand the glue, the DNA, and the core logic that creates the foundation for their organization's growth and success.

In this brief eBook, we present a summary of five of the top corporate culture stories of 2015. These stories center on the UK-based global retailer *Tesco*, the German auto giant *Volkswagen*, the dominant internet retailer *Amazon*, the Chinese online marketplace *Alibaba*, and the electric car start-up *Tesla*. We look at their business situations, the responses of their organizations and their leaders, and the lessons that we can all learn from their experience.

One of the most basic lessons that we can learn from all of these stories is about what makes a business story a good "corporate culture" story. In our experience, a good business story becomes a culture story when there are three closely related components of the organization that need to change. The most basic component is the people's *mindset*—the perspective that individuals hold can often be more rooted in the successes and failures of the past than it is in their plans for the future. A "failure of the imagination" can place real limitations on an organization's future.

But mindset can only be translated into action through the second major component, *leadership behavior*. Behavior is driven by mindset, but is also strongly influenced by context and must be actively managed in "real time" to build the level of capability and alignment that can drive an organization forward.

But it is the third component—the *organizational system*—that is in many ways the most powerful influence. When people work together over time, they always create their own "way" to get things done. "The way we do things around here," as Tom Peters put it years ago, is still probably the most useful way to describe corporate culture. "The people make the place." And over time, the system that has been created develops lots of inertia and tends to resist change.

Culture change is always complex, because it always involves these three components. If one part is changed, but not the others, the changes will never really stick. On the other hand, when leaders orchestrate a re-alignment among these three components so that they reinforce one another, change starts to accelerate.

All 5 of our stories highlight the importance of seeing these three components of the culture more clearly and understanding how essential they are to building a successful future.

TESCO
THE FAILURE OF SUCCESS

1

TESCO HISTORY

- Founded 1924
- Leading UK grocery chain in 1950s and 1960s
- Global expansion since 2001: Asia, Eastern Europe
- Opened Fresh and Easy chain in U.S. in '07, sold in '13
- Accounting scandal broke in 2014
- By end of 2015: stock price halved, £6bn losses reported, fraud investigation taken over by Britain's Serious Fraud Office

British grocer Tesco is one of the great success stories of the retail trade, becoming one of the world's three largest retailers with a mix of retail outlets that ranged from small convenience stores to massive hypermarkets. It was built on the foundation of Tesco's founder Jack Cohen's motto, "Pile it high, sell it cheap." The presence of "a Tesco on every corner" was both a source of humor among the British people and a source of pride among the nearly half-million employees who worked for the company at its height. Tesco's global expansion began in 2001 by building their presence in European and Asian markets and then entering the market in the USA.

Tesco's focus on delivering value for their customers in all segments of the retail marketplace allowed them to build a sense of trust that Tesco meant value. But that strong position, especially in the UK market where it became almost a monopoly, led to a changing mindset about how Tesco could sustain its remarkable success. Gradually, they began to take advantage of their dominant position to demand more from their customers, their suppliers, and their retailers.

Their customers soon realized that, despite the "value" promotions, Tesco's prices were higher than several of their competitors. A once-successful Clubcard program gradually became a confusing mix of "deals" and "offers" that shoppers began to question. Suppliers also became frustrated with years of what one executive called "wringing money out of everyone," leaving them no room for bargaining. New competitors, particularly German discounters Aldi and Lidl, gained in the marketplace. When cosmetic giant L'Oréal sued Tesco for demanding a £1M promotional payment, One of the most vital things for any retailer is gaining the trust of your customers. And that means providing low prices. Losing that reputation was very damaging to Tesco.

SIR TERRY LEAHY, FORMER TESCO CEO

other suppliers began directing their promotional programs to Tesco's competitors.

These sorts of demands for "commercial income" led to a crisis in 2014 when it came to light that Tesco had reported $388M in phantom profits for a six-month period. By the end of 2015, Tesco stock had been halved, they had reported a £6B loss, their executive suite was in disarray, with three CEOs in a five-year period, and they were under investigation by Britain's Serious Fraud Office.

And things weren't going any better in the USA. Fresh & Easy, Tesco's US grocery chain, had been designed to be a cross between a health food boutique and a convenience store, starting in three western states in 2007. Despite market research to the contrary, Tesco thought that American shoppers would welcome the European-style convenience of small shops they could visit several times a week for fresh food and prepared meals. But their own market research, which had shown that Americans travel by car and like to buy in bulk, proved to be correct. Fresh & Easy filed for bankruptcy in 2013, was sold, and then in 2015, closed all of its stores.

Today, with new leadership, Tesco is back on the path to recovery, but has a long way to go to regain their former glory.

Lessons for Leaders

1

> Once customers start shopping around, they are hard to bring back.
>
> FORMER CEO LEAHY

While Tesco is primarily a retailer, its downfall carries several key messages for executives in many other industries.

Your customers know value.

When customers found it difficult to find value in Tesco stores, they looked elsewhere. As former CEO Leahy said in a 2015 interview, "I think that some of that trust eroded which has meant people have shopped around." Once customers start shopping around, they are hard to bring back.

Living up to your reputation can tempt you to cut corners.

To continue their tremendous record of success, Tesco was tempted to cut corners. When challenges began to erode their market share, Tesco cut corners by transforming innovative loyalty cards into gimmicky, no value promotions. And they turned their promotions into a form of supplier bullying, requiring suppliers to pay cash up front to be included. The "phantom profits" in the 2014 accounting scandal, in fact, were promotional payments that Tesco booked prior to actually receiving them. Suppliers will work hard so that you both succeed, but when pushed too hard, or squeezed too much, they will often turn their attention to your competition.

VOLKSWAGEN AG

A TERRIBLE MISTAKE BY A FEW PEOPLE?

2

Volkswagen had accomplished their ultimate goal: they had overtaken Toyota as the world's largest car company.

11 million
Number of vehicles fitted with the deceptive software

up to 40X
Nitrous oxide emissions in excess of EPA regulations

$500
Rebate VW offered to every owner of an affected vehicle

nearly 50%
Drop in VW stock value within a week of the story breaking

only a few
VW employees CEO claimed were involved in the scandal

Over the last decade, VW had accomplished their ultimate goal: They had overtaken Toyota as the world's largest car company. "Be aggressive at all times" was their mantra and they wore their successes very proudly. Perhaps too proudly.

But in mid-September, Volkswagen's diesel emissions scandal burst into the news. "Defeat" devices had been fitted to eleven million vehicles since 2008. This software "fix" activated the cars' emissions control systems to meet the EPA standards—but only during testing. On the road, VW diesels emitted up to 40 times as much nitrous oxide as the standards allowed.

Within a week, VW CEO Martin Winterkorn, had resigned and the stock price had dropped by nearly half. Winterkorn claimed that he had no knowledge of the problems. "Do you really think that a Chief Executive had time for the inner functioning of engine software?" he asked. The problems were due to the "terrible mistakes of a few people." The new CEO, Mathias Muller, continued with this explanation claiming that "only a few employees were involved in this deception."

But Michael Horn, President and CEO of the VW Group of America, saw it differently. As he put it, "We've totally screwed up. Our company was dishonest with the EPA, the California Air Resources Board and with all of you."

VOLKSWAGEN AG
A TERRIBLE MISTAKE BY A FEW PEOPLE?

2

As the story unfolded, it became obvious that it was difficult to blame this all on a small group of engineers. There were a lot of critical stakeholders involved and it soon became clear that VW had to have created an extensive "tangled web" as they developed this technology, implemented it, outsourced its production to top auto supplier Robert Bosch, and prevented anyone, including their Board members from finding out for nearly a decade. The management had been demanding and aggressive, and their organization had cut a few corners to deliver.

Lessons for Leaders 2

Here at VW in the last few years, we have forgotten to say,

'I won't do this.'

'I cannot.'

'I'm sorry.'

VW ENGINEER

Culture matters.

Scaling up *anything* requires building a culture and mindset that supports it. If the VW deception had been perpetrated by a small group acting against the core values of the culture, it's likely they would have been outed within 18 months. As long-time VW engineer put it, "Here at VW in the last few years, we have forgotten to say, 'I won't do this.' 'I cannot.' 'I'm sorry.'"

Crisis management.

When confronted with a crisis involving wrongdoing, the best approach is to come clean and make clear how you will fix the problem. Best practice in this area has been clear for years. This is how Johnson & Johnson's then-CEO, James Burke, handled the Tylenol crisis in 1982, and he actually enhanced his standing as a public figure and J&J's corporate culture in the process.

Governance.

German auto expert Ferdinand Dudenhoffer was blunt about it: "Volkswagen has no corporate governance." VW is owned by the Porsche family (over 50%), the German state of Lower Saxony (20%), and a Qatari sovereign wealth fund (12%), with the remaining 10-20% being publically traded. The capacity of the Board to represent shareholder interests and serve as a check on the Management Board are very limited because they are so closely intertwined. As the story continues to unfold, and we learn who knows what when, we can only hope it will lead to governance reform that will, in turn, lead to reform of the corporate culture.

AMAZON
PUSHING THE WHITE-COLLAR ENVELOPE

3

The company is conducting an experiment in how far it can push white-collar workers to get them to achieve its ever-expanding ambitions.

JODI KANTOR & DAVID STREITFELD,
"Inside Amazon: Wrestling Big Ideas in a Bruising Workplace" - New York Times, August 15, 2015

It was hard to miss the firestorm that exploded over Amazon in late summer, 2015, when the *New York Times* published a lengthy critique of the online marketplace's corporate culture. Some Amazon customers professed themselves to be outraged and promised to take their business elsewhere. Business writers, from major publications to unknown blogs, took up the fight. Was it an outrageous example of corporate culture run amok? Or was this just the voice of a few disgruntled employees unable to compete with their peers in a high performance culture? Or was it just how things go in companies with grand ambitions? When Amazon CEO Jeff Bezos chimed in a few days later, he earned both raised eyebrows and a lot of nods when he said, "Our culture is friendly & intense, but if push comes to shove, we'll settle for intense."

Bezos is a controversial character, but his success with Amazon is a compelling story. Amazon's stock rose from $38 to over $500 per share in just seven years under his leadership. Despite thin profit margins, investors have maintained their faith in the business model that Amazon has created, in part because it still maintains the intensity of a start-up, even with 200,000 employees.

But one of the most remarkable aspects of the Amazon story is how little actual evidence was brought to bear on the discussion. The original story relied on a powerful series of interviews with former employees, and the avalanche of commentary just drew on individual perspectives of Jeff Bezos and others. But it is not difficult, in almost any major organization, to find former employees who didn't get what they want and resent how hard they worked trying to get it. Is Amazon an anomaly? Or is this

AMAZON
PUSHING THE WHITE-COLLAR ENVELOPE

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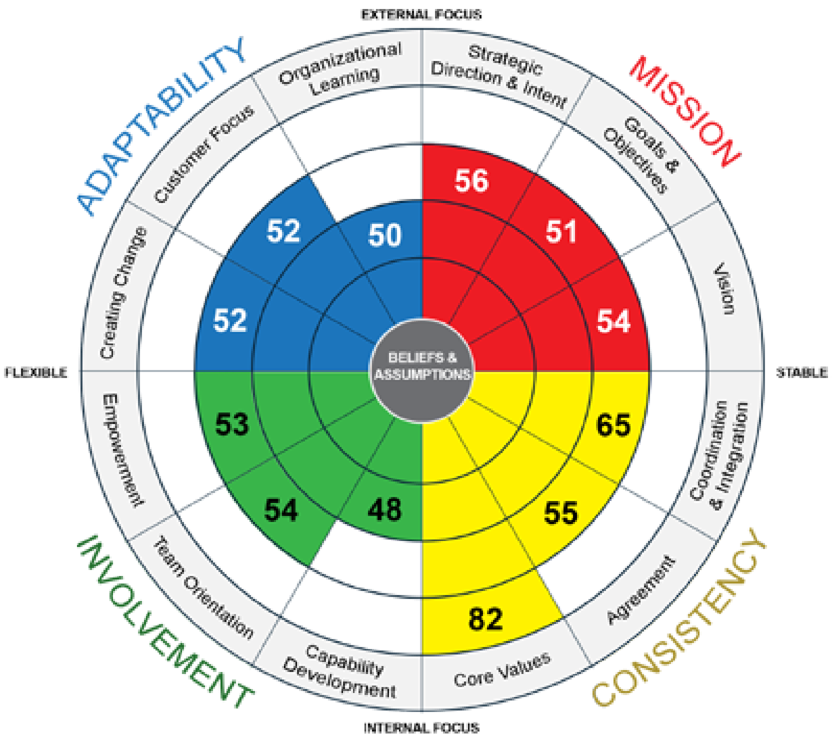


simply a provocative story about a situation that is unfortunately more typical than we would like to admit?

To address this important question, we applied a new technique that we have developed to profile the culture of an organization using the abundant social media data that is available for any large organization these days. We profiled Amazon using several hundred postings about the firm taken from Glassdoor. This profile summarized overall themes in the data, but also categorized the comments about Amazon in terms of our well-known organizational culture model.

The simple way to interpret our profiles is that "more color is better." The numbers on the profile are percentile scores, which compare this profile against a benchmark of over 1000 global companies. So, for example, a score of 54 on the vision index means that Amazon's Glassdoor comments about their vision were higher than about 54% of the companies in our benchmark database. Overall, most of Amazon's culture scores using this method were not too far from the 50th percentile, meaning that they were not too far from average. The one exception to this, the core values index, shows that the distinctive character of Amazon's culture does shine through loud and clear.

These results seem to show that Amazon's culture indeed creates a tough place to work. Many people who can't stand the pressure and stress leave. It appeals to people who have a compulsive need to succeed at the highest level. But even though Amazon's culture can be harsh and demanding, it is, judging from this analysis, far from uncommon.

Lessons for Leaders

3

It’s dangerous not to know what your employees think.

Hyper-competitive work environments.

When the stakes are high, the pressure rises. The intensity can create a lot of focus, but it can take its toll. The differences between those who are succeeding and those who are not can become very clear. For some people that’s not a good fit, and this system takes the risk of sometimes driving out effective employees who just don’t thrive in an environment of high stress and competition.

It’s dangerous not to know what your employees think about your company.

As our analysis shows, harsh and demanding corporate cultures are all too common. But employees, especially those with highly valued skills, have choices in employers. The cost of turnover can be a significant drag on profitability and performance. What do your employees value in your company?

Some companies appeal to people who have a need to achieve status and success.

Amazon’s blending of a stack ranking system (grading employees along a bell curve) with a 360-degree evaluation system has created an environment where certain personality types seem most likely to succeed: those who see high employee evaluation ratings as akin to status and success. It may work at Amazon. It may or may not work as a more general business model.

ALIBABA
THINKING FIVE YEARS AHEAD

4

- **1999** Alibaba Founded
- **2003** Created Taobao
- **2005** Received $1B investment by Yahoo!
- **2007** IPO on Hong Kong Stock Exchange
- **2010** Launched Taobao mobile app
- **2014** IPO on New York Stock Exchange
- **2015** Founded MyBank
  Struck deal to purchase *South China Morning Post*

This case is a dramatic success story that is now unfolding on a global scale. Alibaba is one of China's leading companies and is becoming a competitive threat to major western companies like Amazon, EBay, and Google. Alibaba was founded in 1999 as a B2B online marketplace for goods produced in China, it expanded into B2C, and then into C2C in 2003 with the creation of Taobao. In 2005, Yahoo! invested $1B in Alibaba. In 2014, Alibaba completed the largest IPO in NYSE history ($25B). It is now the largest online marketplace in the world, and accounts for 60% of all packages shipped in China. Its founder, former English teacher Jack Ma, is China's richest person.

Already an economic giant in China, Alibaba's vision is to "build the future infrastructure of commerce" for the world. And they're in it for the long haul. "We envision that our customers will meet, work and live at Alibaba," says their website, "and that we will be a company that lasts at least 102 years."

Last June, they founded MyBank, an online-only lender, to help facilitate transactions in their online marketplace. In December, they became a player in the media market, buying Hong Kong's English-language *South China Morning Post* in order to have a bigger influence shaping China's public image.

Despite its size and ambitions, Alibaba is known for always putting customers before stakeholders and sees itself as a stimulator, not a crusher, of small business. "We are not an e-commerce company," Ma said at Stanford University last September, "although we have the largest e-commerce company in the world. We enable other companies to become e-commerce companies. Every company

4

We envision that our customers will meet, work and live at Alibaba.

STATEMENT ON WEBSITE - 2015

should be able to become an Amazon." Similarly, MyBank is aimed at the smaller-business segment not well served by China's existing banks.

"Most companies, when they are doing good, they enjoy today's wonderful life," says founder Jack Ma. "They don't worry about five years ahead. But I worry about five years ahead." Ma sees the future of online marketplaces as cellphone-centric. But it is yet to be seen how far they can go in building a leading global company.

Lessons for Leaders

4

Most companies, when they are doing good...don't worry about five years ahead. But I worry about five years ahead.

JACK MA, FOUNDER, ALIBABA

Be distinctive.

To be a big success, you have to be different. Alibaba has been distinctive since the very beginning. They don't really imitate anyone else. They simply focus on building their own infrastructure to serve their customers.

Values count.

The successful organization you build will be a strong reflection of you and your most important values. Alibaba has been shaped by Founder Jack Ma's values and worldview since the very beginning. For example, even though Alibaba has grown to be a global giant, they continue to be concerned about serving small businesses, as shown by their recent entry into banking through MyBank.

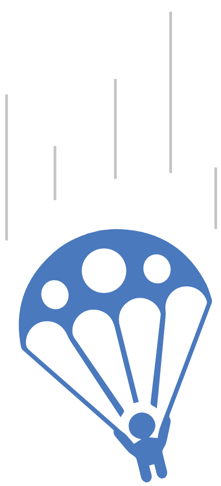
Think five years ahead.

Thinking five years ahead is a compulsion shared by many great leaders. Alibaba is focusing their attention on how to best facilitate global commerce in a mobile world and thinking far into the future in order to do it. Short term achievement is important, but only because it is in service of the long term vision.

TESLA
A TECH COMPANY THAT BUILDS CARS

5

> We take leaps of faith that are like jumping out of an airplane and designing and building the parachute on the way down.
>
> DOUG FIELD, TESLA VP OF ENGINEERING



How do you revolutionize one of the most complex, competitive, and well-established industries in the world? Tesla has done this by creating a culture that prizes proven problem-solvers, is built on knowledge from outside the auto industry, and champions speed and agility. Elon Musk, the founder of Tesla, is a seasoned force of disruptive innovation, creating both PayPal (1998), and SpaceX (2002), before launching Tesla Motors in 2003.

Big disrupters often enter a market through the low end of the price spectrum, producing an innovative product so cheaply that it becomes available to an audience who previously couldn't afford it. Think Henry Ford.

With Tesla Motors, Musk has turned this definition on its head. Rather than creating less expensive versions of an established class of cars, Musk's team is producing luxury electric vehicles (EVs). While meeting production levels is an ongoing challenge, they have already become the leading vendor of EVs in the US, selling 2.5 times more here than global leader Nissan Leaf.

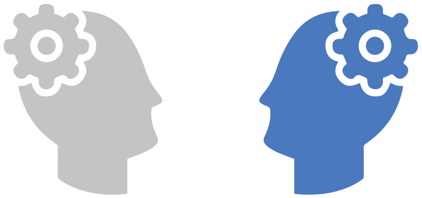
So what is the key to Tesla's disruptive innovation? The most potent difference is mindset.

Speed.

Tesla's Model S sedan, when equipped with the "Ludicrous" option, accelerates from 0 to 60 in under three seconds, making it the fastest production sedan in the world. But it's not only their cars that go fast. Musk is focused on rapid development—of systems, technologies, and, yes, cars.

The best perk you can give smart people is the chance to work with other smart people.

GEORG ELL, TESLA'S UK AND IRELAND DIRECTOR



When Tesla enticed Chief Information Officer Jay Vijayan away from tech company VMware, Musk tasked him with creating software from scratch to run the entire company—from product planning and testing to sales and accounting. He challenged Vijayan and his team to do it with far less time and resources than they had ever imagined. The team had it up and running in four months.

Really smart people.

Tesla selects employees based on their experience solving complex problems. "'We always probe deeply into achievement on the résumé,' says Musk. 'Success has many parents, so we look to find out who really did it. I don't care if they graduated from university or even high school.'" The biggest draw for talent is not money (salaries are below industry standards, though stock options are included), but challenge and the chance for "smart people to work with other smart people."

A tech company that happens to make cars.

Tesla consciously built the company on people from outside the auto industry. There are very few "car guys" around. Its EVs are really laptops on wheels. They track user data in real time and the cars receive software updates automatically via the Internet, allowing them to improve performance over time. They follow the Open Source model in developing software—it's available to everyone, including competitors, to use and improve upon.

TESLA
A TECH COMPANY THAT BUILDS CARS

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Tesla's manufacturing processes borrow from the aerospace industry, including casting techniques used in SpaceX's Falcon rockets.

Tesla is also investing heavily in battery technology. Partnering with Panasonic, it is building a $5B lithium battery "Gigafactory" in Nevada. The goal is to scale production to radically reduce battery costs—enough to permit production of "entry-level" luxury EVs.

Perhaps more important in the long run is Tesla's investment in the self-driving or autonomous vehicle, which it touts as a core part of its mission. This is the next big thing for the entire auto industry—not just the EV niche.

Though Tesla may not yet have turned a profit, it remains an innovator to watch.

Lessons for Leaders 5

The more dramatic change you want to create, the more important mindset becomes.

Mindset.

The most potent factor is mindset. When people see a different product, a different technology, a different market, or a different business model, they design around that. When you use a mindset different from the traditional one in your industry as the foundation, you can create a disruptive innovator. Mindsets change the leadership, and in turn change the systems and behaviors. The more dramatic a change you want to create, the more important mindset becomes.

Speed.

If time is money, what is your return on time? With real-time monitoring of their entire fleet, Tesla is creating a transformative approach to repairs and updates. Being fast and agile is a big magnet for smart people who want to work with other smart people.

The best ideas may be from outside your current experience.

The place where you get the different mindset may come from someone who grew up in a different business and has different expectations. "Other car auto companies do it this way" is not an accepted brainstorming entry at Tesla. Ideas and approaches from other industries have been transformative.

Lessons for Leaders

5

Of course, the proof is in the pudding; and though they've done impressive things, they face some significant challenges. Tesla is not yet profitable. They have yet to meet a targeted new model delivery date, and the infrastructure required for charging their cars is not yet in place. Nevertheless, outside investment remains strong, and in 2015 they continued to gain a lot in scale and credibility.

Each of the 5 stories in this eBook presents us with a compelling story of how important the culture of an organization is to its success over time. Either sustained success over decades or an emerging crisis can both be intricately linked with the character of the organization. These stories all remind us that “culture challenges” in organizations tend to have three distinct components.

Mindset.

Tesco’s success over the decades was due to their frugal, accessible, and ambitious approach to serving their UK customers. They created value. This simple principle took them to the very top of the retail industry. But once they became the dominant player, this mindset changed. They began to focus on using their near-monopoly position to command a bigger and bigger slice of the pie, and tried to sell this to the rest of the world. Before long, their customers began to see that the value being created wasn’t for them. That began the decline.

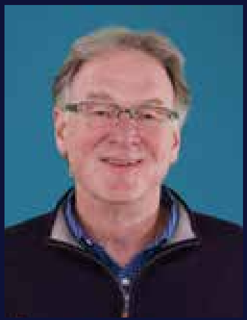
Leadership behavior.

VW’s choice to deny corporate responsibility for the diesel emissions scandal and try to blame this on the “terrible mistakes of a few people” was a big mistake. It wasn’t credible, internally or externally, and raised doubts about the company that went far beyond the original wrongdoing. While there were many VW people who saw the problem, the first instinct of the leaders was to deny their culpability. As leaders, we make choices that have broad impact, and we speak through our actions. It’s hard to “take it back” after the fact, and our behavior can have an impact that lasts for a long, long time.

The organizational system.

Amazon, Alibaba, and Tesla are all examples of organizations with visionary founders who have taken a new mindset, created a new way of leading, and built a new organizational system to deliver on a unique value proposition. From Tesla's identity as a "tech company that happens to build cars," to Alibaba's focus on building the world's most enabling online marketplace, to Amazon's challenge of maintaining a start-up culture with 200,000 people, these organizations have built a new and unique culture that serves as a core logic for building an innovative organization for the future.

We hope that these stories give us all some important lessons to consider as we plan how we address our own organizational challenges for 2016.



Sincerely,

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